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TAGS: ECON ENRG EINV EPET EFIN PREL CH
SUBJECT: CHINA/ENERGY: NEAR-TERM FUEL PRICE HIKES UNLIKELY

SUMMARY

¶1. (SBU) Beijing appears unlikely to raise retail fuel prices significantly in the near-term amidst policymakers' ongoing concerns about CPI inflation and social stability. The most commonly purchased blend of gasoline is held at USD 2.92/gallon, while diesel is USD 2.89/gallon. Against the backdrop of rising global oil prices and recent retail fuel price hike announcements in Malaysia, India, Taiwan, and Indonesia, NDRC Vice Chairman and Director General of the National Energy Bureau Zhang Guobao stated on June 8 that China's current finished oil prices are conducive to the country's social and economic stability. Economists argue that China's sound fiscal situation will enable the government to maintain domestic retail fuel prices through subsidies for the foreseeable future. Domestic gasoline and diesel shortages could eventually force regulators to raise prices, but it appears that concerns about CPI inflation will continue to wield greater influence on pricing policy through the Olympic Games in August.
END SUMMARY

TOP ENERGY POLICY MAKER DEFENDS SUBSIDIES

¶2. (SBU) Following the Five Party Energy Ministerial in Japan on June 8, NDRC Vice Chairman and Director General of the National Energy Bureau Zhang Guobao stated to media that China's current finished oil prices are conducive to the countryQs social and economic stability. China last raised domestic retail fuel prices in November 2007, by 8-9 percent. Zhang expressed concern about the economic consequences of aligning too quickly with international prices, especially for the agricultural sector. China therefore has to defer finished oil price reform in order to promote policies that are favorable to social and economic stability. Zhang dismissed the idea that rising demand in developing countries such as China and India should be blamed for the surge of global oil prices, arguing that investments by hedge funds and other speculators have played a key role in recent trends.

GRADUALISM

¶3. (SBU) Zhang's comments reflect China's longstanding efforts to keep oil price volatility from harming consumers and threatening social stability, in particular in rural areas where farmers depend heavily on diesel fuel. Dr. Zhao Jianping, a Beijing-based World Bank energy analyst told us that there is a general consensus among Chinese leaders that domestic retail fuel prices should reflect the real costs of production, but domestic inflationary pressures and the rapid rise in international oil prices have deterred regulators from implementing market-derived pricing formulas that have been

proposed over the past several years. Zhao noted that CPI, which was up 8.5 percent yoy in April and 7.7 percent yoy in May, will continue to make it challenging for the government to raise retail fuel prices. He projected that even if the State Council approves an upward price adjustment later this year, the new domestic prices would still be well below international prices. Meanwhile, the government will continue to offer subsidies to its national oil companies to offset refining losses.

STRONG FISCAL POSITION MEANS SUBSIDIES AFFORDABLE

¶4. (SBU) Economists argue that China's sound fiscal situation will enable it to continue to finance subsidies and further delay retail price hikes. According to a recent report by Morgan Stanley economist Qing Wang, China is in a relatively favorable position to maintain subsidies compared to its peers in the region due to its low government debt levels, which reflect consistently low fiscal deficits. In Wang's view, China's fiscal strength suggests that if the government continues to maintain domestic retail fuel prices through subsidies, it can afford to do so at least for the foreseeable future without running into a debt sustainability problem. Moreover, if the government decides to increase prices, it can afford to do so incrementally. HSBC economist Hongbin Qu's research echoes Wang's conclusions. According to Qu, 20 percent yoy growth in tax revenues over the past five years has made China well-positioned to cover the explicit costs of the estimated USD 40 billion in annual subsidies, assuming international oil prices remain steady and the government continues its policy of subsidizing approximately 40 percent of refiners' losses from imported crude oil.

SHORTAGES

¶5. (SBU) Beijing has the fiscal means to sustain subsidies, but retail fuel shortages may ultimately force regulators to raise prices according to a June 9 article in a well-informed local Chinese economic weekly, Caijing magazine, by economist Andy Xie. Domestic media has reported gasoline and diesel shortages in rural areas, and emboffs have observed long lines and limited diesel supplies both at fueling stations in Beijing's suburbs and during travel to interior provinces. Diesel shortages are expected to be especially acute during the summer months, as farming activities reach a peak and reconstruction begins in earthquake stricken areas. Beijing has taken steps to encourage Sinopec and Petrochina to increase finished fuels production, including by offering rebates on value-added taxes on gasoline and diesel fuels. Despite such incentives, both companies continue to report refining losses.

COMMENT: NOT FOLLOWING NEIGHBORS' FOOTSTEPS

¶6. (SBU) Comment: Policy makers in Beijing are well aware of the distortions caused by fuel price subsidies, especially with regard to energy consumption and environmental degradation. At the same time, top officials have declared inflation to be the top near-term economic challenge. Further, social stability is extremely important in the lead up to the August 8-24 Olympic Games. Given China's strong fiscal situation and its current economic priorities, the government appears to have both the motivation and ability to maintain fuel price subsidies at minimum until later this year, and it is likely to do away with those subsidies only gradually.